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MACROECONOMIC POLICY QUESTIONS: FINANCING OF DEVELOPMENT

The sources of finance for development at mid-decade

Report of the Secretary-General

SUMMARY

In its resolution 48/187, the General Assembly requested the Secretary-General to submit a report to it at its fiftieth session on the potential sources of financing for development. In responding to that request, the present report focuses its analysis on the levels of saving that could be used to finance investment and the channels for allocating savings to particular investments.

Following a brief introduction (paras. 1-4), the report finds in section I that under current policy plans, there are encouraging prospects over the near-to-medium term for the global volume of saving and the saving by the developing countries as a whole. Aggregate saving by the developing countries, however, mainly reflects the high saving rates that have accompanied rapid economic growth, especially in many Asian countries. The potential for greater saving exists in Latin America and can be realized if adjustment programmes are maintained and sustained economic growth resumes. The situation in many African countries is more difficult, due to the constraints of low levels of income and slow economic growth (paras. 5-21).

The report reviews in section II the factors that determine the development of the main channels of financial intermediation between savings and investment in developing countries, namely, (a) development of the domestic financial sector, (b) access to international private sources of finance, including trends since the Mexican exchange-rate crisis at the end

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of 1994, and (c) official flows, particularly official development assistance. A most serious development in this regard is the decline in the total volume of aid in the past two years and the likelihood of further aid cut-backs (paras. 22-52).

The report concludes in section III with observations, questions and practical recommendations for international policy in the three key sectors of finance for development mentioned above (paras. 53-71).

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INTRODUCTION

1. Concern that there are not sufficient financial resources for development has been a preoccupation of international discussions of economic and social affairs at the United Nations from the earliest years of the Organization's existence. The potential sources for the financing of investment are domestic and foreign savings, and two questions thus arise: (a) whether enough savings are placed at the disposal of private and public investment in developing countries and (b) whether those savings are used to finance the most appropriate investments. The first question raises macroeconomic issues concerning domestic saving and the net transfer of foreign saving to developing countries; the second question raises microeconomic issues concerning the role of government and the financial sector in intermediating between savers and investors.

2. The request by the General Assembly, in its resolution 48/187, to prepare a report for its fiftieth session on financing of development underlines the continued importance of the issue in international policy debates. In 1991, the Secretary-General proposed that consideration be given to convoking an international conference on development financing; the proposal was debated through 1993, albeit inconclusively (see A/48/367, p. 3).

3. Recent developments in private and official flows, however, have put the long-standing questions of development financing in a new context, in which the volatility of private flows is more highly appreciated and the significant future growth of official flows, particularly official development assistance (ODA), cannot be taken for granted. Policy makers in some developing countries have thus begun to focus on the disparate characteristics of different types of private financial inflows and many now question the wisdom of early and complete liberalization of the capital account in international transactions. Meanwhile, in some of the developed countries, the prospective role of development assistance itself is being re-examined. A related concern is that the foreign debt difficulties of developing countries - debt owed to both private and official creditors - have for the most part not yet been resolved in a durable manner more than a decade after the debt crisis burst onto the international political stage. That matter is, however, the focus of a companion report (see A/50/379).

4. The main conclusion of the analysis presented here is that in the short to medium term, the world economy seems able to generate the savings needed to finance global investment, including that of the developing countries. It is not so clear, however, whether those savings will find their way in adequate amounts to the more desirable places and will be used for the more desirable projects in terms of equitable, sustainable and efficient development. This will depend on the development of the financial sector in developing countries; economic reform and socio-economic policy more generally; the ability of private and public investors in developing countries to tap international financial resources; and the flow of official resources for development.

I. IS THERE ENOUGH SAVING FOR DEVELOPMENT?

5. Observers of the world economy have been asking for many years whether there is a nascent shortage of saving in the world and how the developing countries would fare in the competition for funding if an actual shortage were to emerge. The question is important, even if the answer is elusive.

A. Global saving behaviour

6. Economists disagree about how to detect a saving shortage, since total savings at any given moment will have been invested in one form or another. Adherents to classical economic thought argue that a rise in real interest rates would be evidence of a saving shortage, since in their view financial markets balance the supply of savings and the demand for investment by changing the prices and earnings on financial instruments. The economics profession has come a long way since John Maynard Keynes challenged that view of the savings/investment process; thinking about the issue today by most economists is much more nuanced. In fact, real interest rates in the 1980s for loans in major currencies were significantly higher than they were in the 1970s, according to some very approximate measures. However, the real interest rate is notoriously difficult to measure. And to offer it as evidence of a global-level saving shortage, one would have to calculate a global real interest rate that embodied the expectations of inflation in a variety of currencies over an indefinite future, and would also have to take account of actual interest rates in each of the relevant markets: all in all, a formidable research task.

7. Another approach that suggests that there might be a global saving shortage notes that the share of gross world product that was invested in the 1980s appeared to fall: perhaps investment had become inadequate in some sense, which must mean that savings were inadequate as well. Yet, because the prices of investment goods fell relative to those of the goods and services that make up current expenditures, the real extent of the decline in the investment share of output was substantially overstated. And although there was still a decline after correction for price changes, new evidence has shown that the prices of capital goods were falling even faster than price indices reported, owing largely to an underestimation of the revolution in computer technology, so that real investment behaviour was not as weak as data suggested. But in any case, this approach does not lead to any conclusion about the adequacy of savings supply: there is no a priori reason that investment should be a fixed share of output. If investment spending has declined as a share of output, it might be for reasons that are independent of whether or not there is any savings shortage. This approach is thus as inconclusive as the global interest rate approach.

8. Finally, those concerned about the adequacy of world savings have observed that the share of gross domestic saving in the gross domestic product (GDP) of the developed market economies was lower in the 1980s than it was in the 1970s: 22 per cent versus 24 per cent. 1/ As in the case of the investment indicator noted above, however, price changes - in this instance, changes in the terms of trade of the countries concerned - explain a significant part of the measured decline. Moreover, the remaining decline seems to have been concentrated in the

United States of America, since the real saving of high-income Europe as a share of GDP essentially stabilized in the late 1970s, while that of Japan soared. 2/

9. In the United States, as in other industrialized countries, gross private saving has been on a downward trend, but the most dramatic development has been the drop in saving by general government (combining all levels of government). Since 1982, the United States has not even covered total current expenditures with current revenues, let alone financed any of its public-sector investment; in other words, the government sector of the United States has until recently been "dis-saving".

10. Nevertheless, in the mid-1990s the attendant growth in public debt in the United States and many other industrialized countries has become a substantial policy concern and Governments are putting significant efforts into deficit-reduction policies. 3/ According to the International Monetary Fund (IMF), the general government deficit of the industrialized countries peaked in 1993 at 4.4 per cent of GDP and is on its way to 3.4 per cent in 1995 and 3.0 per cent in 1996. 4/ Projections by the Organisation for Economic Cooperation and Development (OECD) based on medium-term fiscal consolidation plans show a further percentage point decline in the general government deficit of the industrialized countries from 1996 to the year 2000. 5/ In short, although government intentions may not be realized and economic prospects are always uncertain, the contribution of the government sector to the weakening of saving in the industrialized countries is likely to be attenuated. Admittedly, this does not mean that the industrialized countries will generate adequate savings in some absolute sense; it does mean that more resources will be available for investment globally.

11. Most importantly from the perspective of the present report, the weakening in savings in the industrialized countries over recent years does not seem to have had a lasting impact on investment in the developing countries. The aggregate share of investment in nominal GDP in the developing countries, which fell in the 1980s, has since returned to roughly what it was in 1980, in contrast to the lower figure in the developed market economies (see table 1). 6/ In recent years, moreover, the growth of investment in real terms in the developing countries has been strengthening. It has already become quite strong overall and shows less volatility than in the previous two decades, which were greatly affected by the large swings in oil prices and the debt crisis (see figure 1).

12. The investment share for the developing countries as a group is composed of very different subgroups of data. Asian developing countries, especially China, have generally high rates of investment, while investment rates in Africa and Latin America have seriously faltered under the weight of adjustment, debt and development crises (see table 1).

Table 1. Investment and savings of developing and developed countries, 1980-1993

(Percentage of gross domestic product)

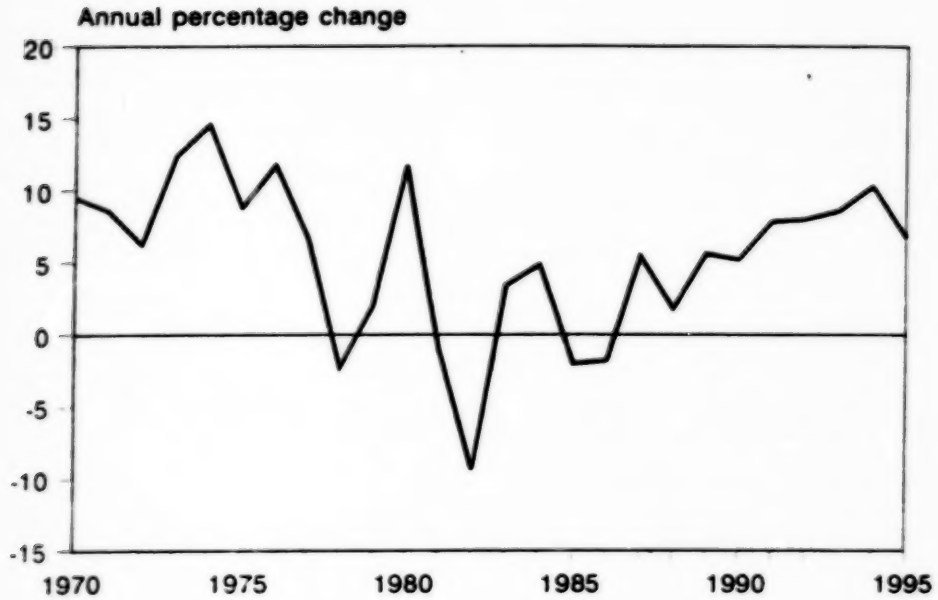
	Gross domestic investment				Gross domestic savings			
	1980	1985	1990	1993	1980	1985	1990	1993
All developing countries a/	26.1	23.7	25.3	25.5	27.0	24.2	26.2	25.1
Latin America	24.8	19.1	19.6	19.6	23.6	23.7	21.9	18.0
Africa	25.6	20.2	20.5	18.2	25.2	19.6	19.3	16.0
West Asia	24.5	21.2	21.5	23.6	41.3	20.2	26.2	22.2
South and East Asia b/	26.3	24.6	29.8	29.5	24.0	24.6	29.0	30.1
China	32.2	40.5	37.2	37.7	32.2	36.5	39.9	38.7
Developed market economies	23.4	21.4	22.2	20.3	23.7	21.8	22.2	21.7

Source: *World Economic and Social Survey, 1995* (United Nations publication, Sales No. E.95.II.C.1), tables A.5 and A.11.

a/ Excluding former Yugoslavia.

b/ Excluding China.

Figure 1. Growth of real investment a/ in the developing countries, 1970-1995



Source: Department for Economic and Social Information and Policy Analysis of the United Nations Secretariat.

a/ At 1990 prices and exchange rates.

13. But what of the future? If the African and Latin American economies are to return to the earlier era of relatively high GDP growth, investment rates will have to rise substantially. Low-income developing economies, such as China and India, as well as economies in Africa and Latin America, have a host of long-term investment needs. Investment demand in the rapidly growing middle-income Asian economies is also expanding rapidly, especially for infrastructure, since sustained and high economic growth has created serious bottlenecks. Where will the savings for these additional investments come from?

B. Saving in developing countries

14. On the whole, developing countries have financed virtually all their investment out of domestic saving. The net transfer of resources - the difference between gross domestic investment and gross domestic saving - has not been more than plus or minus 1 per cent of the GDP of the developing countries since 1980, a year of unusually high oil prices when oil exporters placed substantial surplus resources in other countries. Analytically more revealing is the very different behaviour of regional subgroupings of countries.

15. As table 1 shows, the regions with the higher and still growing investment shares in GDP have also had the higher savings shares; indeed, despite investment of almost 30 per cent of GDP in South and East Asia and 38 per cent of GDP in China in 1993 - the latest year for which relatively complete data are available - saving exceeded investment in both areas. Rising savings have thus been adequate to finance increases in investment in the region, although the member countries of the Association of South-East Asian Nations (ASEAN), excluding Brunei Darussalam and Singapore, are notable in their current need for external financing to fill the growing resource gap resulting from the rapid rise in their investment.

16. In Africa and Latin America, investment and savings shares were lower in 1993 than in 1980 and net resource transfers from abroad made significant contributions to investment financing in 1993 in both regions. In Africa, the decline in the savings share has outpaced the decline in the investment share and there has been an increased reliance on external transfers. Latin America saw a shift from a net outward transfer in the 1980s that was related to the foreign-debt crisis to a net inward transfer, as foreign investors brought funds in and domestic residents repatriated overseas holdings. In some Latin American countries, such as Argentina and Peru, the share of investment rose in the 1990s and was largely funded by these new external transfers. In other countries, such as Mexico, while the share of investment in GDP remained stable in the 1990s, consumption increased rapidly and savings fell, requiring the use of the new resource transfers to help to finance that investment.

17. Several factors explain the differences in domestic saving among regions and countries, although their impact varies in countries with different income levels. 7/ The positive effect of income growth on savings is the most clearly established. More rapid economic growth of the slowly growing countries, particularly in Africa and Latin America, could generate a virtuous cycle by promoting investment along with the higher saving that accompanies growth, which

would in turn bolster further growth. By the same token, the high-growth economies can be expected to sustain their saving performance.

18. Reductions in budgetary deficits also seem to have a positive effect on private savings in developing countries: they give a double boost to the savings gain from deficit reduction. 8/ Most of those gains, however, have already been obtained, since very substantial budgetary corrections were made in the late 1980s. But additional budget corrections and other forms of deficit reduction will help to bring additional gains. According to IMF estimates, the central government deficit of the developing countries fell from 6 per cent of GDP in 1987 to 3.3 per cent in 1990, remained in that vicinity through the first half of the 1990s, and is expected to fall to 1.9 per cent in 1995 and 1.6 per cent in 1996. 9/

19. Reaching a sustainable macroeconomic configuration has a more general positive effect related to the fiscal correction factor, not so much on the level of savings per se as on the amount that savers retain in the domestic economy. This is because the high saving segment of the population in most countries usually has the capacity to evade foreign-exchange controls; people in this group can thus maintain personal savings goals even if the attractiveness of placing savings within the domestic economy is small. The effectiveness of foreign-exchange controls has always depended on the cost of evasion being high relative to the gain from moving funds offshore, and in today's more integrated financial markets, the ability to evade such controls seems generally greater. However, successful economic stabilization and adjustment also reduces the attractiveness of moving funds to other countries.

20. A final important factor that bodes well for savings is the substantial decline in the dependency ratio of the population in developing countries, that is, the share of the population that is under 15 or over 65 years old. Because population growth is slowing in many countries - mainly through a decline in birth rates - their dependency ratio should continue to decline for many years. 10/ With this change in population structure, savings rates can be expected to be boosted.

21. All in all, in the countries that are already growing rapidly - particularly in Asia - the potential for savings to remain strong is high. For the countries that are emerging from the long winter of debt crisis and adjustment - mainly middle-income countries - prospects for generating and retaining substantial additional domestic savings seem to depend on their returning to more rapid rates of economic growth and ensuring the maintenance of domestic adjustment programmes. For low-income, slowly growing countries - especially but not exclusively in Africa and not including all African countries - there does not seem to be scope for substantial growth of the savings share in the next several years.

II. ALLOCATING SAVINGS TO INVESTMENTS

22. Whatever the level of domestic savings and however large or small the net transfer of foreign savings, there is legitimate concern to ensure that those savings are allocated to investment in developing countries in a manner that is

efficient and desirable in the social, political and developmental senses. In addition to sector-specific determinants, this outcome depends on some general policy considerations that have become more salient in recent years. First, if a country's legal system is not well developed, with appropriately specified property rights and laws of contract and an effective enforcement mechanism, then interactions between savers and investors have to be governed by other social mechanisms, such as family or other personal relations. The implication for the selection of investment proposals that get funded is obvious: some good proposals never get a hearing and some inappropriate proposals are implemented, perhaps with subsidies arranged through relationships with officials.

23. The capacity of the price system to accurately reflect relative scarcities is also important to efficient investment design, as are appropriate public policies to address classic market failures, such as in the generation of pollution or the provision of infrastructure. An effective government planning mechanism is essential if necessary social investment - especially for human-resource development - is to be well designed, and is even more essential for efficient government guidance of the investment process in those countries that choose to have activist industrial, agricultural or other sectoral policies. Moreover, a sustainable macroeconomic situation, including external debt-servicing obligations that are within a country's debt-servicing capacity, helps to draw domestic and foreign investors into long-term investment commitments. Another important consideration is the nature of the financial system itself, which is the mechanism for informing potential savers and investors about opportunities for mobilizing savings and for applying them to investments.

A. Financial-sector development in developing countries

24. The financial sectors of most developing countries up until the 1980s consisted broadly of a formal and an informal segment. Banking systems dominated the formal sector, where there was heavy reliance on direct government control in the pricing and allocation of loans. Non-bank institutions (such as pension funds, insurance companies and merchant banks) and capital markets were less developed, and there was very limited access to international sources of finance other than direct investment and syndicated bank loans, mainly for middle-income countries. 11/ As a result, largely separate, informal systems of savings and credit developed outside the larger and regulated systems, either providing substantial funds in aggregate to enterprises with limited access to formal-sector credit, as in the case of the "curb" market in the Republic of Korea and other countries, or providing micro-loans to the segments of the economy that were not part of the formal production sector, as in rural areas in many parts of the developing world. 12/

25. More recently, there has been a spate of financial-sector reforms across the developing world, as countries have sought to move towards more market-oriented systems. 13/ Reform measures have been wide-ranging and are aimed at significantly reducing the direct intervention of government and increasing reliance on the market. They include the decontrol of interest rates to raise rates on savings deposits and loans; the reduction of subsidized credit directed to the promotion of specific sectors or enterprises; the privatization of banks and reduction of restrictions on private banking and other financial activities;

the development of domestic capital markets; and the easing of restrictions on foreign investment in the domestic banking system and capital market. The role of government is thus becoming more indirect but is still crucial for providing financial legislation and a system of prudential regulation and supervision of the decentralized financial system.

26. Although with these reforms many functions of the informal financial sector will be absorbed into the formal system, some components of the informal sector may still be needed, particularly where small-scale production activities are important in the economy or where there is a very large rural sector, because the informal financial sector has an advantage in transaction costs when dealing with small-scale clients. Indeed, it is thought that Governments should seek to strengthen these specialized functions and that linkages with the formal sector should be developed to integrate the two sectors. 14/

27. Difficult experiences with financial reform in Latin American countries in the 1970s heightened international sensitivity to the importance of an appropriate sequencing of reform measures. The prerequisite for financial-sector liberalization is now thought to be macroeconomic stability, followed by the ending of interest-rate controls and credit allocation, and the phased withdrawal of the direct participation of government in the financial sector. In the experience of many developing countries, banking institutions have often been severely weakened during periods of economic decline and structural adjustment and need to be restructured or recapitalized. The infrastructure of the banking sector - its legislative framework, prudential regulation and supervisory systems, as well as its economy-wide systems of accounting and financial information - must be developed and put in place to promote stability of the financial sector.

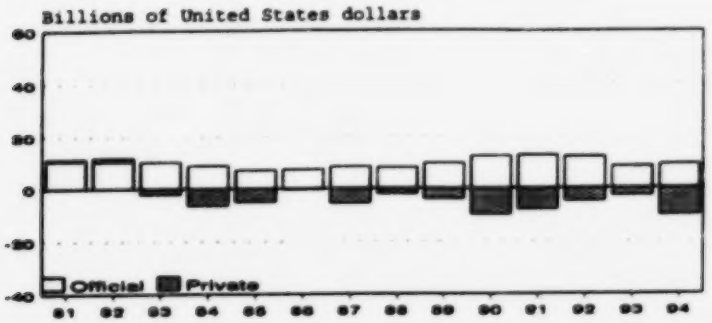
28. Another dimension of reform concerns its degree of integration into international markets. There is general agreement on the advantages in the long term of liberalizing international financial flows, albeit after domestic reforms and liberalization, but there is a wide variety of thinking about the pace of liberalization and how much of the broad range of international financial flows to include. A particular concern in recent years has been the potentially destabilizing effect of foreign financial flows on domestic financial markets and the market for foreign exchange. In contrast to the problems of the highly selective and limited availability of foreign private flows in the 1980s, the problem of the early 1990s has been how to cope with flows that could surge to any number of countries. 15/

B. Tapping international finance

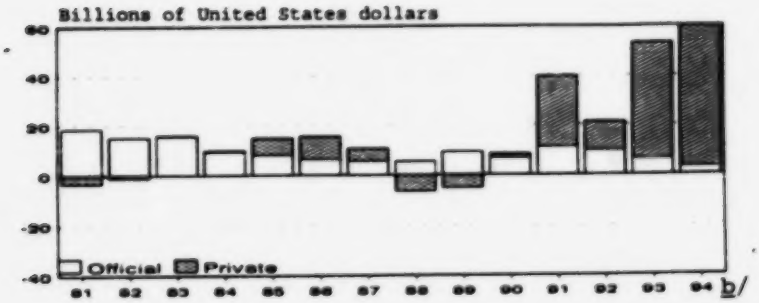
29. The three largest developing country regions have had very different degrees of success in drawing upon private financial resources in the international arena. Figure 2 highlights the experiences of Africa, Asia (excluding West Asia) and Latin America in terms of the net transfer of financial resources associated with all private actors, including developing country wealth holders who invested overseas, all flows being counted as net of payments of investment income. The contrast with the net transfer vis-à-vis foreign official donors and creditors is also shown. 16/

Figure 2. Net official and private transfers of resources to Africa, Asia a/ and Latin America, 1981-1994

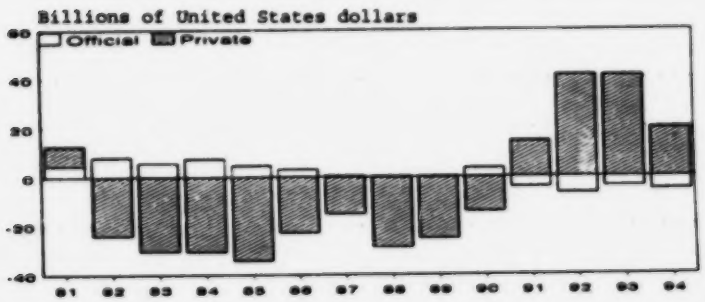
Africa



Asia a/



Latin America



Source: Same as figure 1.

a/ Excluding West Asia.

b/ Preliminary.

30. The situation in Africa is especially striking and reflects, more than anything else, the development crisis in much of the continent. The world's private sector has been withdrawing funds on a cash-flow basis for over a decade: interest and dividends paid abroad do not generally come back as new credits and investments, new foreign lending and direct investment in Africa are relatively sparse, and some domestic funds leave the region.

31. But this is not the case in every African country and private capital inflows have increased somewhat in recent years, albeit from a very small base and at a much slower pace than inflows to other developing regions. Some countries, such as Morocco, South Africa, Tunisia, Uganda and Zimbabwe, have seen an increased inflow of private capital; in 1994, for example, South Africa recorded the first net capital inflow since 1984, comprising mainly commercial bank loans and public and private international bond issues. Continued privatization and financial and foreign investment liberalization in several countries, including Côte d'Ivoire, Egypt, Kenya and Zambia, are expected to lead to new direct investment inflows. The new Government and economic reform in South Africa have also created favourable conditions for direct investment.

32. In the cases of Asia and Latin America, the most striking development is the large-scale private inflows that have occurred in the 1990s. Although much has been made of the new flows of investment in the securities of each region, 17/ direct investment has also surged in both regions, particularly in 1993 and 1994 in Asia, where it comprised two thirds of the total net resource transfer.

33. Several factors have been cited to account for the rise in direct investment in the 1990s. 18/ Favourable conditions for sustained economic growth in prospective host countries is a major "pull" factor. Such conditions are usually indicated by economic stability, sound macroeconomic and financial policies, and the degree of market orientation of the economy. Relatively weak exchange rates in the host country provide a cost advantage to foreign investors. Liberalization and simplification of legislation on foreign-direct investment provide increased incentives for investment. In addition, financial and trade liberalization reduces restrictions on the import of inputs and financial flows.

34. Recent measures, such as the privatization of public enterprises and of investment in previously government-monopolized sectors, have created additional investment opportunities, particularly in Latin America and some African countries. 19/ In addition, regional economic integration, whether on a formal basis, as in the North American Free Trade Area and the Southern Cone Common Market, or on a market-generated basis, as in the growth of trade among Japan, South and East Asia and China, has provided a strong impetus for large direct investment flows to developing countries.

35. An important development in private flows that stands out in figure 2 is that the level of 1994 net transfers to Latin America was only half the level of transfers in 1993 and 1992. This change was largely accounted for by a decline in portfolio investment, thus justifying the concern expressed in several quarters that the unrestricted access of developing countries to potentially

"hot" money could expose them to a large degree of volatility in their balance of payments.

36. One reason for the earlier attraction, particularly of Latin America, to financial managers in developed country markets has been the substantial decline in interest rates in the United States of America and other developed countries between 1991 and 1994, which raised the interest-rate premium on developing country placements. Equally significant has been the spreading realization in international financial markets that significant improvements have been made in the economic situation of many middle-income countries. The success of debt-restructuring programmes in regularizing relations with commercial bank creditors, greater political and economic stability, and progress in economic reform in many developing countries, particularly in Latin America, have raised their creditworthiness in the eyes of international investors. Other favourable factors are the opening of developing country markets to foreign investment and the easing of regulations in developed countries on the issuance of bonds and equities by foreign entities. The growing geographical diversification in institutional investment portfolios of developed countries has provided additional impetus. Although such diversification has constituted a very small share of total portfolios, its absolute amount has been very large relative to the size of the financial markets in developing countries.

C. The aftermath of the Mexican financial crisis

37. While the decline in financial flows to Latin America in 1994 raised warning flags, the Mexican balance-of-payments crisis at the end of 1994 has clearly shown the dangers of allowing policy to become dependent on volatile financing.

38. With hindsight (and for many, only with hindsight), it was clear early in 1994 that Mexico had an unsustainably large deficit in its international payments arising from the combination of several years of relatively high inflation and a fixed exchange rate to the United States dollar. Seen in terms of the Mexican new peso, imports became ever more attractive and exporters found it harder to compete in foreign markets. Devaluation would have reversed these disincentives but at the cost of a temporary boost to inflation, since the peso prices of all tradable goods would have risen. However, this had been ruled out for the time being as the fixed exchange rate was seen to be a key feature of the economic stabilization strategy of a governing party that was seeking re-election. The Government had also boosted expenditure and thus its borrowing requirements but it began to have some difficulty in financing its deficit, as political difficulties, such as the troubles in Chiapas and political assassinations, were added to the economic ones. The Government thus shifted to heavy use of short-term financing and introduced an instrument called the tesobono, which paid interest and principal in pesos but at rates keyed to the dollar so that dollar-based purchasers would not bear the risk of loss should there be a devaluation.

39. The Mexican strategy of pegging the peso to the dollar required net capital inflows that would finance the increasing trade deficit. To a dangerously large degree, much of the inflow was of a type that could easily become an outflow.

As investors increasingly became concerned about the Mexican situation, the inflows slowed and Mexico had to draw on its large reserves of foreign exchange to fill the financing gap. By December, that option was no longer feasible and the peso was devalued. But with investors panicking, the peso/dollar exchange rate began a rapid decline that the Mexican authorities could not stem with the resources at their disposal. Under the leadership of the United States of America, an international rescue package of some $50 billion was put together. This seemed to stabilize the situation: as adjustment measures began to show results, calm was restored. Mexico has even returned to the international financial markets, although its terms of credit have been quite expensive. 20/

40. Although the case of Mexico had several unique features, once the crisis began international securities investors suddenly reassessed their risks in all the emerging market economies: the contagious effect of the Mexican crisis left no developing country untouched in the short term. Net flows through short-term debt and equity transactions turned substantially negative in the first quarter of 1995, because of large outflows from Latin America as well as from many ASEAN countries. 21/ Short-term debt was repaid without new inflows, while investments were withdrawn from equity markets. Equity prices fell 28 per cent in Latin America and almost 8 per cent in Asia in the first quarter. New international equity issues plummeted to half a billion dollars in the first three months of 1995, down from almost $6.5 billion in the fourth quarter of 1994. There were no new Latin American issues, and issues for Asian enterprises were less than 10 per cent of their value in the previous quarter.

41. Even the less volatile medium and long-term bond markets were shaken. The volume of new developing-country bond issues declined by 58 per cent in the first quarter of 1995, with the decline most pronounced for Latin American bonds. Direct investment was the sector least affected, particularly in the ASEAN countries. In fact, flows to South and East Asian countries increased quite strongly into 1995, boosted by the substantial appreciation of the yen against their dollar-linked currencies.

42. In addition to the decline in the level of flows, the terms and destinations of financial flows were altered significantly, reflecting greater investor discrimination among developing countries in terms of risk. The ability of Malaysia, the Philippines and Thailand to sustain large or growing external deficits in the past few years and since the Mexican crisis is one manifestation of this tendency. At the same time, countries deemed to be high risk face higher costs of funds and a more limited access to credit.

43. This can be seen, for example, in the shortening of the average maturities of bonds offered for sale in the first quarter of 1995: although most new issues were in the range of 1 to 10 years, the maturities of all Latin American issues were less than 7 years. The differences between countries in the cost of funds also increased: five ASEAN countries have seen their credit rating upgraded since the Mexican crisis.

44. Portfolio flows to Asia have resumed since the end of the first quarter of 1995, and flows to some ASEAN countries have accelerated in the second quarter, following the decline in United States interest rates. And with evidence that quick policy adjustments in Mexico as well as in Argentina are reducing trade

deficits, inflows have resumed in the second quarter. 22/ The crisis of confidence is thus passing, although it has left the international policy community shaken and searching for ways to prevent its recurrence, as will be discussed in section III below.

D. A new reality in official financial cooperation?

45. For most of the post-war era, it has been taken for granted that the domestic savings of developing countries need to be supplemented with foreign savings to boost investment adequately and that it is not practical to expect private international financing to do the job: some projects that are developmentally important are just not bankable or practical areas for direct foreign investment. And some countries would have great difficulty in arranging, let alone servicing, any significant amount of credit on commercial terms. Thus, special official mechanisms are needed to intermediate between internationally available savings and investment in the developing countries.

46. As figure 2 indicates, such flows remain especially important to Africa, although they have traditionally played a significant role in Asia as well, particularly in low-income countries. Latin America too has drawn on such resources, albeit primarily the less concessional sources of funds: while it has drawn heavily on IMF, the World Bank and the Inter-American Development Bank, especially in the wake of the 1980s debt crisis and to help set up the collateral for the Brady Plan arrangements to restructure commercial bank debt, Latin America has been making net transfers to the multilateral institutions on a net basis in the 1990s.

47. The multilateral financial institutions make up a major part of the official mechanism for financial intermediation. The development banks raise funds mainly through bonds issued on developed country markets at relatively low interest rates, owing to the implicit guarantee of the bonds by developed country shareholders. IMF has been a special case: its lendable resources are mainly provided as placements with the Fund of some of each country's international reserve assets. Bilateral credits are an additional form of official financial intermediation. Typically, the Government of an industrialized country provides a repayment guarantee for a private bank loan taken by a borrowing country to finance imports from the creditor country, although sometimes the Government of the creditor country provides the loan directly.

48. For the most part, the intermediation activities by official institutions do not require substantial budget allocations from the finance-providing countries. Other official flows of course do, in particular the heavily subsidized loans and grants provided bilaterally or through multilateral channels, principally the concessional affiliates of the multilateral development banks, the International Fund for Agricultural Development and the operational agencies of the United Nations system. Such flows are not so much financial intermediation as transfers from Governments of donor countries to Governments of developing countries. For decades, the ODA expenditures of industrialized countries have had broad support among taxpayers and legislators, and in some countries they still do; as the data in table 2 suggest, however,

there has been a serious erosion of support in some countries, notably but not exclusively the United States of America, once the largest donor and now a distant second to Japan.

49. Far from implementing the United Nations target for development assistance of 0.7 per cent of the gross national product (GNP) of the donor countries, the overall aid effort of the industrialized countries that are members of the Development Assistance Committee (DAC) of OECD fell to an estimated 0.29 per cent of GDP in 1994, the lowest level in 21 years. As of 1994, only four countries exceeded the United Nations aid target: Denmark, the Netherlands, Norway and Sweden, while the aid effort of France put it near the target at 0.64 per cent of GNP. In aggregate, the volume of DAC aid fell in both 1993 and 1994 and the prospects for a turnaround are not bright at present.

50. Moreover, the capacity of traditional developing country donors to maintain their aid flows has been strained in recent years, owing especially to the cost of wars and their aftermath in West Asia and the relatively low price of oil. 23/ The total amount of aid from developing country donors is estimated by OECD to have remained at about $1 billion a year since 1992, a decline from earlier levels.

51. From this perspective, it is not an exaggeration to say that today the international community is facing a crisis in official development assistance. Until recently, ODA has been a regularly growing source of finance. Even after two years of decline, net receipts of ODA by developing countries still exceeded $58 billion in 1994, a substantial amount of funding. But the international community has been chiding donors for decades to improve the quality of aid by untying it from purchases in donor countries, providing it on more concessional terms, devoting more of it to least developed countries, enhancing coordination with other donors for maximum impact and so on, all the while pushing for an acceleration in the volume of flows. Apparently, the emphasis must now fall more heavily on improving the efficiency and effectiveness of aid, since the growth of ODA itself can no longer be taken for granted.

52. Current efforts to replenish the resources of the African Development Fund (AfDF), the concessional arm of the African Development Bank, offers a warning about the difficult and protracted negotiations that can ensue today before donors and recipients are able to reach an accommodation: no new AfDF loans have been made since January 1994.

Table 2. Official development assistance of member countries of the Development Assistance Committee of the Organisation for Economic Cooperation and Development, 1974-1994

	ODA/GNP (Percentage)			ODA volume a/ (Percentage change)		ODA amount (Millions of United States dollars)
	1974	1984	1994 b/	1993	1994 b/	1994 b/
Australia	0.55	0.45	0.38	0.3	4.9	1 087
Austria	0.18	0.28	0.29	-0.2	-1.7	561
Belgium	0.50	0.58	0.30	-2.9	-20.7	677
Canada	0.47	0.50	0.42	-0.1	-1.1	2 230
Denmark	0.53	0.85	1.03	1.6	2.5	1 450
Finland	0.16	0.35	0.31	-31.2	-27.4	289
France	0.44	0.62	0.64	-0.2	3.2	8 447
Germany	0.38	0.45	0.33	-6.4	-6.9	6 751
Ireland	0.09	0.22	0.24	30.8	24.1	105
Italy	0.13	0.28	0.20	-9.2	-35.8	1 967
Japan	0.25	0.34	0.29	-12.3	7.9	13 238
Luxembourg	0.00	0.16	0.40	34.6	13.4	59
Netherlands	0.61	1.02	0.76	-4.6	-3.6	2 531
New Zealand	0.31	0.25	0.24	-1.0	1.2	111
Norway	0.57	1.03	1.05	-10.8	11.2	1 137
Portugal	0.00	0.04	0.34	-8.8	17.9	296
Spain	0.00	0.08	0.26	-5.0	3.7	1 247
Sweden	0.69	0.80	0.90	-6.0	-7.3	1 703
Switzerland	0.14	0.30	0.36	-28.6	12.1	978
United Kingdom	0.40	0.33	0.30	1.4	1.5	3 085
United States	0.25	0.24	0.15	-19.0	-4.9	9 851
Total	0.30	0.34	0.29	-5.9	-1.8	57 800

Source: Development Assistance Committee.

a/ Prices and exchange rates of previous year.

b/ Preliminary.

III. WHAT ROLE FOR INTERNATIONAL POLICY?

53. Almost all investment in the developing countries will someday, be financed by private savings. Not only will relations between business investors and savers mainly be intermediated by the financial sector but public investment will be financed principally by selling government bonds. Savers will act individually and through institutions, such as pension funds, many of which will be private, although some institutions are likely to be government operated in most countries. Most savings used in an economy will originate there but a portion will be foreign and it can be expected that the spreading international diversification of financial portfolios will eventually make the distinction between the behaviour of foreign and domestic savers increasingly hard to discern.

54. That day, however, is far in the future for all but a small number of middle and upper-income developing countries: there is still a major need today for international policy to bolster the financing of development. Three broad targets of international cooperation may be highlighted: financial sector development, facilitated access to international finance and official development assistance.

A. Financial-sector development

55. Perhaps it is best to acknowledge first that there is no shortage of advice on how to reform and develop the financial institutions and markets of developing countries and that not all such advice has equal value. Fads in policy design have repeatedly swept across segments of the community of policy advisers, only to be followed by reassessments after unanticipated difficulties have arisen. 24/ No single model of financial development applies equally well in all institutional, cultural and technological situations. There is no one proper sequence of financial reforms for all countries or for all times. Financial sector policy is part and parcel of the national planning of development strategy and of macroeconomic stabilization needs.

56. The point is that the core of international cooperation in this field is in the nature of technical cooperation, even if there is some official financing of financial sector development. In this context, the best model of international cooperation seems to be that of helping policy makers to pose questions and formulate policy options that have their respective advantages and disadvantages outlined as fully as possible, rather than providing them with answers. Encouraging exchanges of experiences within and across regions of developing countries also fosters the adaptation and redesign of foreign models of reform and turns them into reforms that are owned by the domestic establishment. As in most areas of policy-making, the essence of the process is a cumulative experience of learning by doing.

B. Access to international finance

57. Two words capture the essence of developing countries' capacity to draw on private international financing: confidence and profit. To some degree,

expectations of high profit can overcome a low level of confidence: foreign funds and investors have occasionally been drawn into high-risk situations. But a measure of confidence is required to attract the types of financing that embody the long-term commitments warranted for most investments in developing countries, and that are needed to generate the additions to gross national income with which to pay interest, dividends and profits to foreign suppliers of financing.

58. Basically, two approaches have been followed to international assistance in this area and both remain essential. The first approach has sought to reduce the risk of investing in or lending to developing countries. Standard World Bank loans are examples of the latter: the private saver buys a World Bank bond and the Bank lends the proceeds to a developing country Government. Another example is the World Bank mobilization of commercial bank co-financing of projects that are also supported by multilateral loans, in which explicit and implicit guarantees are embodied in a joint funding arrangement. Multilateral investment guarantees are a further example: they insure direct investors against non-commercial risks. Strengthening international capacity in terms of both approaches entails making sure that the multilateral institutions have adequate capital resources.

59. The second approach to international assistance entails supporting the efforts of Governments to build confidence through policy reform. The multilateral institutions, especially IMF and the World Bank, have also been at the centre of the international effort to reduce the risk associated with the developing country debt crisis. Most recently, on the heels of the Mexican payments crisis and the contagion factor described above (see paras. 40-43), the Governments of the major creditor countries have sought to bolster international confidence in developing economies through a strengthened early-warning system based on enhanced surveillance of economic policies. For decades, private finance has looked warily upon countries undergoing balance-of-payments adjustment, although those that had active IMF stand-by agreements were considered to have an international seal of approval of their policies. The new approach is to involve IMF more closely in policy dialogues with countries that have not sought formal adjustment programmes.

60. Accordingly, consultations should become more frequent and IMF discussions and reports more candid and pointed. Greater attention should be given to countries of global significance, such as Mexico, where adverse developments can spill over and reduce market confidence in other countries. Eventually, however, all countries that do not already have active IMF programmes will be subject to enhanced consultations with the Fund. The major objective of the consultations would be to induce national policy changes before financial market distress becomes unavoidable. But there is no mechanism to precipitate national policy changes by an unwilling Government, and there is often sufficient ambiguity in a situation so that different policy advisers might come to different conclusions.

61. Another aim of the new initiative is to improve the promptness, regularity and transparency of key economic and financial data that Governments supply to the Fund and the world at large. Indeed, influencing the financial market's evaluation of a country's policies by means of publication of IMF country

reports is considered a potent means to influence policy change. The difficulty here is in walking the fine line between releasing a study that would forestal a crisis and releasing one that would precipitate a crisis. In any event, Governments that seek to bolster domestic and international confidence should underwrite the capacity of their statistical and information systems to provide appropriate data on a timely basis.

62. The new initiative recognizes, moreover, that even the most effective surveillance and supervision might fail to prevent national financial crises and, consequently, the capacity to mobilize large amounts of funds in a very short period is needed. In this regard, the summit in June 1995 in Halifax of the seven major industrialized countries has proposed a new standing procedure, an emergency financing mechanism that would provide faster approval of Fund arrangements with strong conditionality and larger up-front disbursements in crisis situations. To support this mechanism, the IMF Group of Ten and other countries with the capacity to support the system have been asked to double as soon as possible the $28 billion currently available under the General Arrangements to Borrow (see A/50/254, annex I, paras. 17 and 18).

63. The difficulty here is that the mobilization and disbursement of large amounts of funds are meant to reassure financial markets that a country in crisis has a short-term liquidity problem and not a more fundamental solvency problem. To students of the early years of the international debt crisis of developing countries, this will sound familiar. Moreover, as the report of the Secretary-General on external debt crisis and development (A/50/379) emphasizes, a large number of middle-income as well as low-income countries are still considered severely indebted. At best, it is very difficult to draw the line between illiquidity and insolvency, as significant liquidity problems usually arise from doubts about solvency.

64. In any event, the very existence of the new credit line is meant to deter speculation. But while it certainly is suitable for IMF to update its emergency swap lines, they will barely exceed the amount mobilized in the Mexican case: determined speculation against the currencies of one or more middle-sized countries could still defeat a war chest of the size proposed. It might thus be prudent to threaten speculators with an additional weapon to discourage a run on an overvalued currency, namely, the internationally supported imposition of temporary exchange controls, to be coupled with an adjustment programme that would eliminate in an appropriately phased manner the policy inconsistencies that provoked the speculative run in the first place.

C. Official development assistance

65. It is not clear how a further erosion of ODA flows can be stemmed, let alone reversed. But how donors shrink their aid programmes may be as informative as the quantitative cut-backs imposed. First, under budgetary pressure donors pare down bilateral programmes, since most multilateral flows entail multi-year commitments. But when the time comes to negotiate multilateral replenishments, additional multilateral resources are seen as coming at the expense of already stretched bilateral programmes, which are usually perceived to bring political benefits or to respond more closely to

donor Government policies and priorities, since the donor itself is responsible for their supervision and control. Thus, in the budget battle multilateral funds can suffer, especially if the replenishment contributions of each country are set by a fixed burden-sharing formula.

66. When donors reduce their bilateral programmes, some seem to choose to concentrate their assistance on countries in which their economic and political involvement is greater. Others respond to budgetary pressure by trying to preserve and emphasize programmes with a strong anti-poverty element. When programmes are ended, sometimes it is a kind of graduation, and sometimes it is more like triage. And, as in the case of Belgium's ODA in 1994, aid disbursements can plummet because one or more major recipient countries sink into a condition that makes continued assistance impractical. The latter type of situation, at least, should be temporary. Certainly, developing countries that embark on the transition from peace-building to development will frequently need substantial amounts of international support, and most of them will need that assistance on less-than-commercial terms, i.e., they will need ODA.

67. ODA is also needed as an integral part of international cooperation on concrete global issues in the economic, environmental and social arenas. This can be visualized as part of a new model of development cooperation in which all countries commit themselves to working towards collective goals, such as eradicating a disease or protecting a fragile environment: they would share relevant experiences and knowledge, but financial resources would have to be provided by those in a better position to contribute. 25/

68. The problem with ODA as a budgetary category on which parliaments in some countries are reluctant to vote more resources is that there is legitimate reason for scepticism and aid fatigue. ODA has been promoted in legislatures in donor countries as a valuable supplementary form of investment financing, even though it has also provided funds for emergency assistance, and has not been promoted as welfare or as income support, although as a tool of foreign policy during the cold war it sometimes provided primarily income support.

69. Moreover, ODA has provided much more than merely finance: it has also provided a means to project into the developing world a self-confident image of the donor country. ODA has often underwritten programmes to introduce or bolster individual donor country institutions, processes and techniques that might or might not be most appropriate to the local situation or fully consistent with what other donors have been promoting with their aid programmes. With the current plethora of mixed assessments of bilateral and multilateral assistance projects and programmes, the hubris behind some traditional ODA programmes is now emerging.

70. Raising the volume of ODA in the future hinges on being able to make the case for its effectiveness in promoting development and achieving shared international goals. The contribution of ODA to development needs to be argued forthrightly. ODA has the potential to play a significant role in a context of true international cooperation, in which the ideas and proposals that it helps to realize are as likely to originate in the recipient countries as in the donor countries. But ODA is also still needed to supplement the low savings that poor

countries can realistically mobilize, domestically and through private international channels.

71. The intention here is not to overstate the role of ODA in development; ODA is a small part of a large picture. Whether the development process in a country begins to gather momentum still primarily depends on the economic, social and political environment that is established in the country and on the international opportunities and shocks that the developing economy confronts. ODA is one such international opportunity, and for many countries, it is a crucial one.

Notes

1/ Although accounting for only about 2 per cent of world output, there was a very high savings rate - and foreign investment of much of those savings - of a group of capital-surplus oil exporters, mainly in western Asia. But with generally weakening oil prices and regional wars, the average saving rate of these countries fell from almost 65 per cent of GDP in the mid-1970s to less than 25 per cent by the late 1980s (see United Nations, World Economic Survey, 1992 (United Nations publication, Sales No. E.92.II.C.1), pp. 67-69).

2/ Ibid., p. 91.

3/ See United Nations World Economic and Social Survey, 1995 (United Nations publication (Sales No. E.95.II.C.1), pp. 55-62.

4/ See IMF, World Economic Outlook, May 1995, table A15.

5/ See OECD Economic Outlook, No. 57 (June 1995), pp. 10-13.

6/ The low share of investment in GDP in the industrialized countries shown for 1993 was associated with their still sluggish recovery from recession. Data for later years are expected to show a rise in this figure (and in savings).

7/ See International Monetary Fund, op. cit., pp. 69-77 for a survey; and S. Edwards, "Why are savings rates so different across countries?", NBER Working Paper, No. 5097 (April 1995) for an analysis of the determinants of savings.

8/ There is an important caveat: if deficit-reduction policy entails a contraction in output and income, the level of savings may be smaller on balance rather than larger, depending on the size and duration of the contraction; i.e., the means and pace of deficit reduction are important.

9/ See International Monetary Fund, op. cit., table A20.

10/ According to the population projections of the Department for Economic and Social Information and Policy Analysis of the United Nations Secretariat, the dependency ratio of developing countries will decline from 65 per cent in 1995 to 62 per cent in 2000 and 59 per cent in 2005 (see United Nations, World Population Prospects: the 1994 Revision (United Nations publication, forthcoming), table A31).

11/ See M. Long, "Financial sector and economic development", in United Nations, Savings and Credit for Development, Report of the International Conference on Savings and Credit for Development, Klarskovgård, Denmark, 28-31 May 1990 (United Nations publication, Sales No. E.92.II.A.1), pp. 52-66.

12/ See P. B. Ghate, "Interaction between the formal and informal financial sectors", in United Nations, Savings and Credit for Development ..., pp. 134-154.

13/ For a review of recent reforms in developing and transition economies, see United Nations, World Economic and Social Survey, 1994 (United Nations publication, Sales No. E.94.II.C.1), pp. 119-125.

14/ See United Nations, Savings and Credit for Development ..., p. 25.

15/ For analyses of the experiences of Argentina, Chile and Mexico, see R. Ffrench-Davis and S. Griffith-Jones, eds., Coping with Capital Surges (Boulder: Lynne Rienner Publishers and Ottawa: International Development Research Centre, 1995). For an Asian case, a cautious liberalization of the stock market of the Republic of Korea, see United Nations, World Economic and Social Survey, 1994 ..., pp. 115-117.

16/ The sum of the private and official net transfers, conventionally termed the "net transfer on a financial basis" in United Nations reports, differs from the net transfer of foreign savings mentioned here, which is the difference between domestic savings and investment and is usually denoted the "net transfer on an expenditure basis". When the net transfer on a financial basis is larger than it is on an expenditure basis, this means that some of the financial inflows were added to official reserve assets and not used to boost domestic expenditures, as in Asia and Latin America in recent years. For additional conceptual details, see United Nations, World Economic Survey, 1986 (United Nations publication, Sales No. E.86.II.C.1), pp. 163-164.

17/ See, for example, United Nations, World Economic and Social Survey, 1994, pp. 109-118.

18/ See United Nations Conference on Trade and Development, World Investment Report 1994 (United Nations publication, Sales No. E.94.II.A.14), pp. 27-28.

19/ See Economic Commission for Latin America and the Caribbean, "Foreign investment and transnational corporations in Latin America: 1995", Notas Sobre la Economíca y el Desarrollo, Nos. 576/577 (May/June 1995); and United Nations Conference on Trade and Development, Foreign Direct Investment in Africa (United Nations publication, Sales No. E.95.II.A.6).

20/ The Government of Mexico successfully placed a $1 billion issue of bonds in July with a yield of more than 5 percentage points (537.5 basis points) above a standard international benchmark, the London inter-bank offered rate; the bond also contained options to convert to shares in privatized Mexican banks or to purchase shares in State entities being privatized.

21/ Statistics for the first quarter of 1995 cited in subsection II.C are taken from Financial Flows and the Developing Countries: A World Bank Quarterly, May 1995, unless otherwise indicated.

22/ See Emerging Markets Data Watch, J. P. Morgan (New York), 1 and 14 July 1995.

23/ One indicator of the situation in oil-exporting donor countries is that export revenues of the member countries of the Organization of the Petroleum Exporting Countries in 1994 were less than half of what they were in 1974 in terms of their capacity to purchase manufactured exports of industrialized countries (see United Nations, World Economic and Social Survey, 1995 ..., p. 42).

24/ Perhaps the most recent case in point is the increasing favour with which direct controls on short-term capital inflows are now viewed and the slower pace of liberalization of developing-country financial markets that this implies.

25/ See United Nations, World Economic and Social Survey, 1995 ..., pp. 138-139.